No. 16,859

IN THE

United States Court of Appeals

For the Ninth Circuit

HAWAIIAN TRUST COMPANY, LIMITED, Trustee for the Creditors and Stockholders of Pacific Refiners, Limited,
Appellant

vs.

UNITED STATES OF AMERICA,
Appellee

On Appeal from the United States District Court for the District of Hawaii

BRIEF FOR THE APPELLEE

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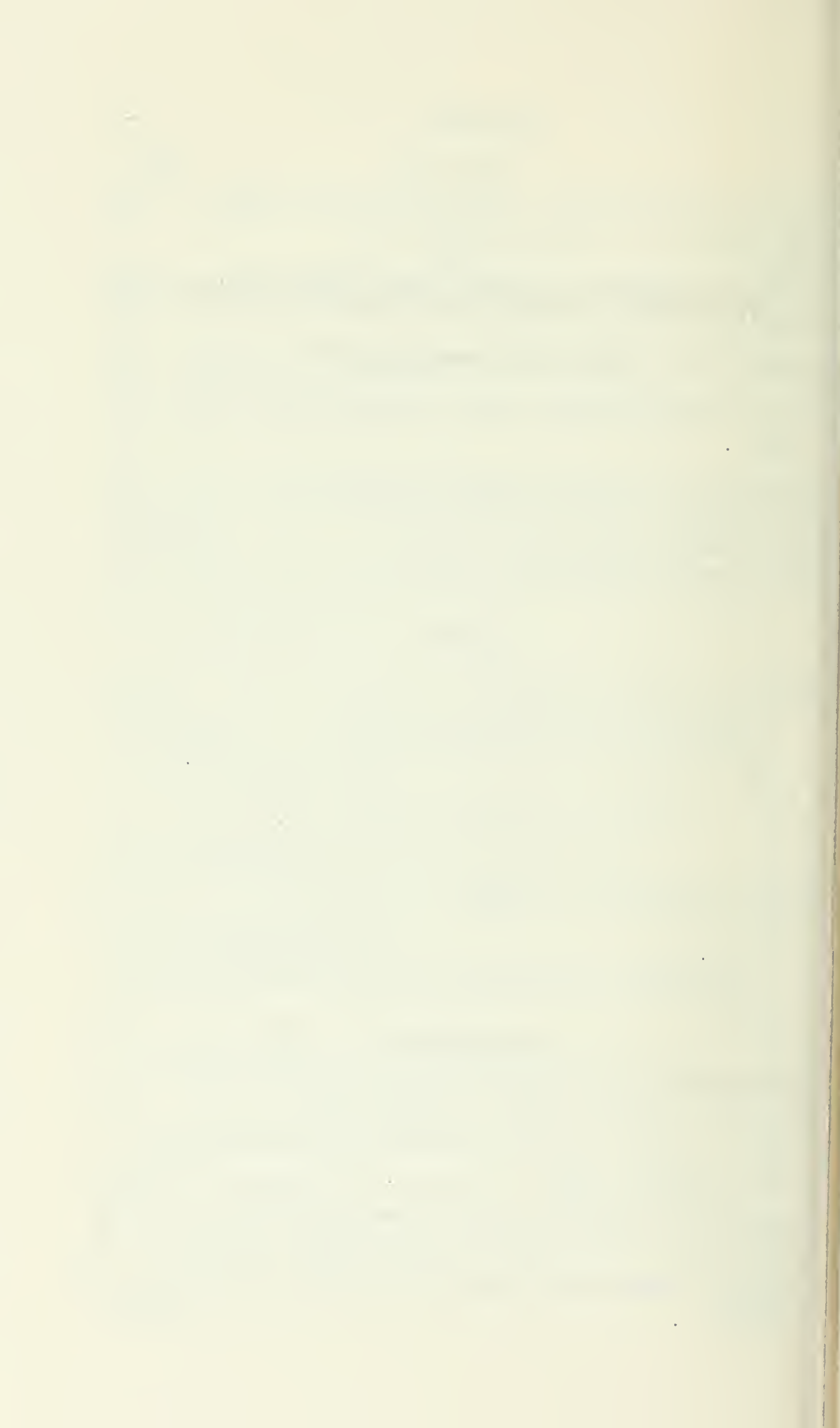

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BRIEF FOR THE APPELLEE

OPINION BELOW

The opinion of the District Court (R. 71-96) is reported at 178 F. Supp. 637.

JURISDICTION

This appeal involves federal income taxes of $58,472.39 for the year 1953 (R. 49) and $51,468.20 for the year 1955 (R. 51). The 1953 taxes were paid on June 4, 1957 (R. 48), and a claim for refund therefor

was filed on August 28, 1957, and was rejected on October 23, 1957 (R. 49). The 1955 taxes were paid as follows: $35,670.31 on June 4, 1957; $1,560.73 on July 26, 1957; and the balance of $18,088.13 by credit on July 23, 1957. (R. 51.) Claim for refund therefor was filed August 28, 1957, and was rejected on October 23, 1957. (R. 51-52.) Within the time provided in Section 6532 of the Internal Revenue Code of 1954 and on January 28, 1958, the suit for recovery of the taxes paid was brought in the District Court. (R. 3-19.) Jurisdiction was conferred on the District Court by 28 U. S. C., Sections 1340 and 1346. The judgment was entered on February 26, 1960. (R. 100-101.) Within sixty days and on March 11, 1960, a notice of appeal was filed. (R. 101.) Jurisdiction is conferred on this Court by 28 U. S. C., Section 1291.

QUESTIONS PRESENTED

1. Whether the District Court erred in holding that a corporation acquiring the stock of another corporation in financial difficulties and thereupon causing all of the assets of the acquired corporation to be sold at a price approximating the cost of the stock, which was substantially less than the cost basis of the stock on the books of the acquired corporation, was not entitled to apply the difference as a loss against its own earnings by filing a consolidated return for itself and the acquired corporation.

2. Whether the District Court erred in holding that the taxpayer could not deduct Territory of Hawaii in-

come taxes allocable to gains from sales in liquidation of the taxpayer, not taxable to the taxpayer.

STATUTES AND REGULATIONS INVOLVED

The provisions of the relevant statutes and Regulations are set forth in the Appendix, *infra*.

STATEMENT

The facts as stipulated (R. 25-68) and found by the District Court (R. 74-84, 96) can be summarized as follows:

The first issue in this has to do with the taxpayer's claim of a deductible carry-forward loss in connection with a consolidated return. The parties principally involved are Pacific Refiners, Limited, hereafter referred to as the taxpayer or Refiners; Honolulu Gas Company, Limited, hereafter referred to has Honolulu Gas; and Hilo Gas Company, Limited, hereafter referred to as Hilo Gas. The appellant, Hawaiian Trust Company, Limited, is involved as trustee for the creditors and stockholders of the taxpayer, which was dissolved on November 19, 1956. (R. 25.) The taxpayer was organized on May 31, 1949, as a Hawaiian corporation. (R. 25.) Its principal business was the manufacture and sale of petroleum products and the distribution of butane (a form of liquefied petroleum gas) in Hawaii. The taxpayer was not a public utility and none of its business was regulated by the Public Utilities Commission of Hawaii. (R. 27-28.) The taxpayer

secured its supply of petroleum products by contract with Standard Oil Company of California under which it was obligated to make a substantial minimum purchase each year. Standard supplied the taxpayer a mixture of heavy gas oil and butane; the taxpayer separated the butane from the gas oil at its refinery in Honolulu and sold the refined products. (R. 28.)

The taxpayer's original capital stock consisting of 250,000 shares of $1 par value common stock was purchased at issuance by Honolulu Gas and distributed as a dividend to the stockholders of Honolulu Gas. Honolulu Gas is a Hawaii public utility corporation operating a manufactured gas business in Oahu and purchasing its gas from the taxpayer. Later, in May of 1950, the taxpayer issued and sold to the public an additional 500,000 shares of common stock through a rights offering. Again, in April of 1951, the taxpayer sold an additional 750,000 shares of common stock to the public through a rights offering. (R. 25-26, 27.)

Hilo Gas was organized as a Hawaiian corporation in 1927. It engaged in the business of manufacturing gas from oil and distributing it through gas mains in the City of Hilo. (R. 29.) It also had a non-utility business—the distribution of bottled liquefied petroleum gas (called "Rock Gas") to rural customers beyond the city mains. (R. 32.) In 1948 and 1949 Hilo lost money and was in financial difficulty. (R. 29.) It appears that Hilo's gas manufacturing plant was obsolete and its production costs were high. (R. 53-54.) In the spring of 1950, Mr. Orlando Lyman, the president and the largest stockholder of Hilo Gas, approached

Mr. Englebright, the general manager of the taxpayer, for assistance in solving the problems of Hilo Gas. Hilo Gas proposed that it give up its manufacture of gas from oil and instead buy butane from the taxpayer, which Hilo Gas would then distribute through its gas mains in the City of Hilo, as a public utility. This would reduce its costs and enable it to compete with electric rates. (R. 29-30.) The taxpayer first made a survey and determined that Hilo's gas mains were in adequate condition to serve as a distribution system, and then offered to supply Hilo Gas with butane. Hilo Gas, however, also wished to secure the franchise for the distribution of the taxpayer's bottled butane for use by rural customers throughout the Island of Hawaii. The taxpayer rejected this proposal and refused to guarantee that its bottled gas (sold under the name of "Isle Gas") would not be in competition with Hilo Gas. (R. 30-31.)

About the middle of September, 1950, when these negotiations fell through, Mr. Lyman offered to sell his shares of Hilo Gas to the taxpayer or to Honolulu Gas. (R. 31.) The executive committee of the taxpayer met on September 16, 1950, to consider this proposal and were advised by Mr. Englebright that the Lyman shares and those of another stockholder could be purchased in a total that would exceed the 75 percent required to liquidate the corporation. (R. 31-32.) Mr. Englebright also reported that the purchase of the Hilo Gas stock was advantageous to the taxpayer to provide it an assured outlet for butane which was highly desirable, if not necessary, in view of the taxpayer's

purchase obligations with Standard Oil. Moreover, unless an attempt was made to perpetuate Hilo Gas, it would probably be dissolved, particularly since certain of its stockholders were interested in the Hilo Electric Company, which would serve as an obstacle to the expanding gas sales not only in Hilo but also in other parts of the Island. (R. 32-33.) Another meeting of the taxpayer's executive committee was held on September 26, 1950, at which the Hilo Gas situation was discussed. (R. 33.) On September 27, 1950, the board of directors of Honolulu Gas authorized the acquisition of the assets of Hilo Gas at a price not to exceed $75,000, subject to the approval of the Public Utilities Commission. (R. 33.)

On October 3, 1950, the taxpayer secured options to purchase 84 percent of all of the stock of Hilo Gas and on October 5, 1950, its board of directors authorized the purchase of all of the stock of Hilo Gas. (R. 33-34.) Eighty-four percent of the stock of Hilo Gas was sold to Refiners on October 6, 1950, and by October 25, 1950, the taxpayer had acquired 96 percent of the stock of Hilo Gas—all but 164 shares. (R. 35.) The total cost to the taxpayer of the Hilo Gas stock purchased by it was $63,897.20. (R. 35-36.)

The original plan of the new controlling stockholder of Hilo Gas (the taxpayer) had been to sell the utility assets to Honolulu Gas, to sell the remaining assets to itself, and to dissolve the corporation at such time as its directors determined in their discretion to be convenient. (R. 43.) At the time of the acquisition of the stock on October 6, 1950, no consideration was given by

the taxpayer to the tax aspects of the transaction. The taxpayer's officials did not know what the book value of the Hilo Gas assets was, and the Hilo Gas books were not made available to the taxpayer until after the decision had been made to purchase the stock. Mr. Lyman of Hilo Gas stated that, so far as he knew, no investigation was made into the accumulated loss of Hilo Gas, nor did he discuss the matter with Mr. Englebright during the negotiations. According to him, the purpose of the purchase of Hilo Gas was to do away with the old manufactured gas plant and replace it with butane shipped in from the taxpayer. (R. 41-42.)

The Hilo Gas stock was purchased by the taxpayer rather than by Honolulu Gas because the taxpayer as the distributor of butane had the primary interest in securing the Hilo market. Honolulu Gas was interested in the utility business of distributing gas through the city mains, but was not interested in the distribution of bottled butane. Another reason for the purchase of the stock by the taxpayer rather than by Honolulu Gas was that an order of the Public Utilities Commission would have been necessary before Honolulu Gas could act to purchase the stock, whereas no such order was required in the case of the taxpayer, and in the view of the taxpayer's management, quick action was necessary. Moreover, the purchase of Hilo Gas stock by Honolulu Gas would have made it a public utility company under federal law, a situation which Honolulu Gas wished to avoid. (R. 34-35.)

Following the purchase of the stock on October 6, 1950, Hilo Gas filed a petition on October 20, 1950,

with the Public Utilities Commission to secure the necessary approval for the sale of its assets to Honolulu Gas for approximately $64,000. The hearing on the application was held on October 26, 1950, and on that date, the Commission issued its order, filed November 15, 1950, authorizing Hilo Gas to sell its utility assets to Honolulu Gas for a total consideration of approximately $64,000, $46,000 in cash and the balance by assumption by Honolulu Gas of the liabilities of Hilo Gas. (R. 36, 53-55.) On October 31, 1950, the taxpayer, holding more than the required three-fourths of all of the stock of Hilo Gas, authorized the sale of the utility assets of the company to Honolulu Gas and the sale to itself of merchandise, bottled gas and gas appliances, and notes and accounts relating to this business for $18,500. Possession of the assets was taken after October 31, 1950 (R. 37), and Honolulu Gas eventually scrapped the manufacturing facilities of the old Hilo plant and converted the pumps and distribution system to the distribution of butane (R. 38-39).

Hilo Gas retained certain assets, in addition to the $64,500 cash received from the sale of its properties. These assets included merchandise parts inventory (for older types of appliances) amounting to $1,010.64, certain accounts receivable, and a lease of an office building in Hilo. The Hilo Gas balance sheet as of December 31, 1950, showed assets as follows: cash in bank—$14,498.76; notes receivable (taxpayer—1 percent interest) $50,000; accounts receivable (other) $531.30; inventory—$904.60; total—$65,934.65. On the same date the balance sheet showed accounts payable of

$647.97 and other current and accrued liabilities of $106.80, or total current liabilities of $754.77. (R. 44.)

The book value of the assets sold by Hilo Gas to Honolulu Gas and to the taxpayer exceeded the consideration paid. The assets acquired by the taxpayer by purchase of the stock for $63,897 had a basis on the books of Hilo Gas for tax purposes of $211,684.90, while the total consideration paid in the sale of the assets was $88,754.32. The utility assets, in particular, were sold to Honolulu Gas for $122,930.58 less than their net book value. (R. 37-38.) In November, 1950, the taxpayer obtained tax advice on the tax aspects of the transaction and was advised that the book loss on the sale to Honolulu Gas would be an allowable deduction in a consolidated return filed by the taxpayer and Hilo Gas, but that this would not be an immediate benefit because the taxpayer did not have any net income. Honolulu Gas was advised that it could not acquire the Hilo Gas assets at their book value in order to take advantage of the loss sustained on the abandonment of the manufacturing plant. (R. 42-43.)

Hilo Gas was not immediately dissolved. It continued its corporate existence and activities until September 18, 1956, when it was dissolved by order of the Treasurer of the Territory of Hawaii. (R. 43.) During this period, the taxpayer and Hilo Gas filed consolidated federal income tax returns for the years 1950, 1951, 1952 and 1953. They filed separate returns for the years 1954 and 1955. Both companies filed separate

territorial income tax returns for the years 1950-1955, inclusive. (R. 40.)

From 1950 until its dissolution, Hilo Gas continued to file the annual reports required by Hawaiian law, to hold annual meetings of the stockholders, to hold periodic meetings of directors, to have an independent auditor, to file federal and territorial income tax returns, to pay income taxes, to own property, to receive income, and to pay expenses. (R. 43-44.) While other possible uses of Hilo Gas were considered (R. 46), its specific activities during this period consisted of leasing property which it sublet to Honolulu Gas and to the taxpayer. Hilo Gas received rental, interest and merchandising income and paid expenses for office supplies, janitor service, directors' fees, pensions to retired employees and federal and territorial taxes. (R. 44-45.) Its income and expenses for these years were minimal. In 1951, it reported total income of $19,294.16, total expenses of $18,324.96 and a net income (before taxes) of $969.20. In 1952, it reported a total income of $10,732.76, total expenses of $10,273.26 and a net income (before taxes) of $459.50. In 1953, it reported a total income of $8,600, total expenses of $5,830.71 and a net income (before taxes) of $2,769.29. In 1954, it reported total income of $8,600, total expenses of $6,009.25 and net income (before taxes) of $2,590.75. In 1955, it reported total income of $8,700, total expenses of $6,063.04 and net income (before taxes) of $2,636.96. (R. 41.) On several occasions after 1951, the question of liquidating Hilo Gas was raised by various of the directors but it was decided

to maintain its corporate existence in view of the possible uses that might be made of the corporation. (R. 46.)

By contrast, the taxpayer's earnings increased substantially during this period. In the year 1950, the taxpayer suffered a loss of $93,092. In 1951, it had a net income of $17,445 and in 1952, $39,147. It did not have to pay any federal or territorial income taxes in those years. In 1953, it had a net income before income taxes of $206,397.20 and after income taxes (as reported) of $167,229. In 1954, it had a net income before income taxes of $215,735.66 and after income taxes (as reported) of $104,977. All of the foregoing figures are on an unconsolidated basis. (R. 40-41.)

As a result of the sale of the utility assets to Honolulu Gas for $122,930.58 less than their net book value, Hilo Gas claimed a net operating loss in 1950 of $117,792.57. (R. 40.) In the consolidated income tax returns filed for the taxpayer and Hilo Gas, the taxpayer included the net loss from the sale of the utility assets of Hilo Gas to Honolulu Gas in computing the net operating loss carry-over to subsequent years. The Commissioner of Internal Revenue disallowed the item on the two-fold ground that (a) in substance, no deductible loss was sustained as the result of the sale of the utility assets of Hilo Gas to Honolulu Gas in 1950; and (b) in the event that a loss was sustained as a result of this transaction, such loss may not be included as a part of a consolidated net loss reported on a consolidated return filed by the taxpayer, as a parent, and Hilo Gas as subsidiary, for the calendar year 1950

since the loss, if any, was sustained in, or was allocable to, the period prior to affiliation and before the consolidation became effective. (R. 46-47.)

On June 4, 1957, the plaintiff, as trustee for the creditors and stockholders of the taxpayer, paid the deficiency with interest assessed against the taxpayer by the Commissioner on account of this disallowance, and a claim for refund was denied. (R. 48-49.)

The second issue in the case has to do with the claim of the taxpayer for a deduction for federal income taxes of Hawaiian territorial income taxes paid on gains not taxable to it under the federal revenue law. These facts, briefly summarized, are as follows:

The stockholders of the taxpayer on November 25, 1955, adopted a plan of complete liquidation which provided for the sale of the refinery facilities to Standard, the sale of the bottled gas business and related assets to Honolulu Gas and the liquidation and dissolution of the corporation. Pursuant to this plan, the refinery facilities were sold to Standard on December 6, 1955, and the bottled gas business and assets were sold to Honolulu Gas on December 31, 1955. Thereafter, and within a period of twelve months from the date of adoption of the plan of liquidation, the affairs of the corporation were wound up, all of the assets of the corporation were distributed in complete liquidation, less assets retained to meet claims, and the corporation was dissolved by order of the Treasurer of the Territory of Hawaii on November 19, 1956. No gain or loss to the taxpayer was recognized on the sale of its assets to Standard and Honolulu Gas, pursuant to the

provisions of Section 337, Internal Revenue Code of 1954. (R. 49-50.)

The gains were, however, taxable under the territorial income tax law and the gains were included in the taxpayer's territorial net income on which it paid total taxes in 1955 of $74,408.15, of which $61,061.59 is allocable to the gains from the liquidation sales. (R. 50-51.) The taxpayer claimed a deduction from its income taxable under federal law for the total amount paid; the Commissioner, however, disallowed the $61,061.59 allocable portion on the ground that Section 265 of the Internal Revenue Code of 1954 "prohibits the deduction of expenses allocable to income exempt from federal income tax." (R. 51.) The appellant paid the deficiency assessed by the Commissioner because of this disallowance and the plaintiff's claim for refund was denied. (R. 51-52.)

The Court below has dismissed the suit for refund, holding that the taxpayer should be denied the benefit of the loss by Hilo Gas through the filing of consolidated returns since it is not established that the principal purpose for the acquisition of the Hilo Gas was not for evasion or avoidance of federal income tax within the meaning of Section 129 of the 1939 Code. In addition the Court also held that aside from Section 129, Section 141 of the 1939 Code, which extends the privilege of making consolidated returns to affiliated groups, may not be utilized to distort income by acquiring a "loss corporation" for a nominal consideration, and then using such corporation's losses to avoid tax. The Court held that the taxpayer, by purchasing

stock at a cost of $63,897.20, which gave it ownership of 95 percent of the stock of a corporation, could not entitle itself to a carry-over of a loss of $117,792.57 attributable to the sale of the assets of the corporation shortly after the acquisition of the stock. (R. 86-87.)

On the second issue, the Court held that under the law and Regulations involved, a taxpayer is not allowed a deduction for the payment of territorial taxes on income which was not taxable here. (R. 94-95.) The Court entered findings of fact and conclusions of law in accordance with its opinion (R. 97-99) and judgment dismissing the complaint (R. 100-101).[1]

SUMMARY OF ARGUMENT

I. The taxpayer here purchased the stock of a corporation in poor financial condition due to obsolete equipment and high costs. The taxpayer then sold virtually all of the assets of the corporation at a prearranged sale, for a price greatly less than the book value of the assets to the corporation, but slightly more than the purchase price of the stock. After the corporation was stripped of its assets, and ready for intended dissolution, the taxpayer deferred dissolution and kept the corporation alive through nominal activities, in order to treat the revived corporation as an

[1]There was a third issue in the case below involving the taxpayer's claim for a deduction in the year of its dissolution of certain expenses incurred in connection with the issuance of its stock. This claim has been abandoned here, and the decision of the Court below holding that the amount was not deductible (R. 91-93) is not in issue here.

affiliate and file consolidated returns with it. The taxpayer filed such consolidated returns for a period of four years, and claimed the book loss to the corporation resulting from the sale of the acquired corporation's assets in 1950 as a carry-forward loss deductible from its earnings in the later years of the period of consolidated returns. After it had served this purpose, the corporation was dissolved.

The Court below properly held that the taxpayer was not entitled to the claimed deduction. It offends specific statutory provisions, including Section 129 of the 1939 Code, and principles of the tax law intended to prevent tax avoidance by distortion of income through the artificial use of corporate devices. The purchase of the stock of a defunct or insolvent corporation in order to acquire a tax loss corporation as an affiliate for consolidated returns has but one purpose, to use the tax loss of another as a deduction from its own income which the taxpayer would not otherwise have. This is flatly prohibited by Section 129 and the finding of the District Court to that effect is supported by evidence and in accord with the decisions of this Court construing Section 129.

In addition, and apart from Section 129, the claimed deduction was not allowable since the privilege of filing consolidated returns cannot be used so to distort income, and the Commissioner could either deny the privilege altogether under Section 141 or allocate this particular loss to the defunct corporation alone, under Section 45. Moreover, affiliation was in reality a sham, which can, on principle, be disregarded for tax pur-

poses. The only real transaction in the case was the purchase of stock in order to acquire the assets, and in such a transaction the only real basis for any gain or loss to the acquiring corporation, the taxpayer here, is the cost of the stock to it, not the book value of the assets to the acquired corporation.

II. The taxpayer was itself liquidated and dissolved in 1956, the proceeds of the liquidation sales of all its assets, less amounts retained to meet claims, being distributed to its stockholders. The gains on the liquidation sale, representing the excess of sales price over cost to the taxpayer, are under Section 337 of the 1954 Code not recognized to the corporation, but taxed, if at all, to the stockholders as a distribution to them in liquidation of a corporation.

The gains to the corporation are, however, taxable to the corporation under Hawaii territorial income tax law. The taxpayer may not deduct the Hawaiian taxes allocable to these gains from its other income taxable under federal law. Section 265 expressly disallows the deduction of any amounts allocable to wholly tax exempt income. Section 265 applies to taxes, and the gains to the taxpayer here, while denominated as nonrecognizable, are in the class of gains wholly exempt from federal tax.

ARGUMENT

I

THE DISTRICT COURT CORRECTLY HELD THAT THE TAXPAYER, HAVING PURCHASED THE STOCK OF ANOTHER CORPORATION AND LIQUIDATED ITS ASSETS IN ACCORDANCE WITH A PRE-ARRANGED PLAN, MAY NOT TREAT THE CORPORATION AS A CONTINUING AFFILIATE IN ORDER TO DEDUCT THE DIFFERENCE BETWEEN THE SALE PRICE OF THE ASSETS AND THE BOOK VALUE OF THE ASSETS AS A LOSS AGAINST ITS OWN INCOME THROUGH THE DEVICE OF FILING CONSOLIDATED RETURNS

A. The finding of the District Court that the primary purpose of the acquisition of the corporation as an affiliate was to evade taxes within the meaning of Section 129 is supported by substantial evidence

Section 129 of the Internal Revenue Code of 1939, Appendix, *infra,* embodies one of the several principles necessary to prevent the avoidance or evasion of tax through artificial or fictitious devices which have no substance or reality. *Commissioner v. British Motor Car Distributors, Ltd.,* 278 F. 2d 392 (C. A. 9th).[2]

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[2]In addition to the House Committee Report quoted in *British Motor Car Distributors, Ltd.* (p. 394) we should like to call the Court's attention to the Senate Committee Report (S. Rep. No. 627, 78th Cong., 1st Sess., pp. 58-59 (1944 Cum. Bull. 973, 1016)), reading as follows:

> The objective of the section, as stated in the report on the House bill, is to prevent the distortion through tax avoidance of the deduction, credit, or allowance provisions of the Code, particularly those of the type represented by the recently developed practice of corporations with large excess profits (or the interests controlling such corporations) acquiring corporations with current, past, or prospective losses or deductions, deficits, or current or unused excess profits credits, for the purpose of reducing income and excess profits taxes. The House report also recognizes that the legal effect of the section is, in large, to codify and emphasize the general principle set forth in *Higgins v. Smith* (308 U.S. 473 [Ct. D. 1434, C.B. 1940-1, 127]), and in other judicial decisions, as to the ineffectiveness of arrangements distorting or perverting

The District Court has found that the taxpayer's claim for a deduction here falls within the prohibition of Section 129 and may not be allowed because the taxpayer has not established that the acquisition of Hilo Gas was not for evasion or avoidance of federal income tax. (R. 86.) We submit that this finding is supported by substantial evidence and is not clearly erroneous. *Commissioner v. British Motor Car Distributors, Ltd., supra; American Pipe & Steel Corp. v. Commissioner,* 243 F. 2d 125 (C. A. 9th); *Elko Realty Co. v. Commissioner,* 260 F. 2d 949 (C. A. 3d), affirming 29 T. C. 1012. As this Court said in *American Pipe & Steel Corp.* (p. 127), dealing with a Section 129 determination by the Tax Court, the finding in this respect "is an express finding of failure of proof, which, if substantially supported by the evidence requires an affirmance of its decision."

The evidence in support of the finding in this case is clear cut. When the taxpayer decided to treat Hilo Gas as a newly acquired affiliate and file consolidated returns with it, Hilo Gas was a practically defunct corporation with a book loss resulting from the sale of virtually all of its assets, ripe for dissolution, and valuable to the taxpayer as a continuing corporate shell only for its book loss as a possible deduction from the taxpayer's income. This was substantially the factual situation present in *British Motor Car Distributors,*

deductions, credits, or allowances so that they no longer bear a reasonable business relationship to the interests or enterprises which produced them and for the benefit of which they were provided.

Your committee recognizes these facts and is in agreement with these objectives.

American Pipe & Steel and *Elko Realty.* The factual differences in this case do not distinguish it from these prior cases, but rather confirm the rule of those cases. In *British Motor Car Distributors,* the taxpayer purchased the stock of a corporation which had just liquidated all its assets at a loss. Here the loss came into existence after the taxpayer had purchased the stock of the corporation and immediately caused its assets to be sold for a loss at a pre-arranged sale. The conversion of the corporation thereafter into a continuing affiliate in order to get the benefit of the loss was purposed primarily to secure "a very real tax benefit to be realized by them [the taxpayer] *through* the acquired corporation and which they could not otherwise have realized." (278 F. 2d, p. 394.)

Indeed, this was the very situation in *American Pipe & Steel Corp., supra.* There, the taxpayer purchased cheaply the stock of a corporation in poor financial condition and immediately thereafter sold its assets at a liquidation sale, resulting in substantial tax losses. As this Court said (243 F. 2d, p. 127): "for a total cost of $11,248.96 to American Pipe, it acquired tax losses of $400,393.91". The taxpayer's attempt to carry forward this loss as a deduction against its income in later years through the device of filing consolidated returns with the stripped corporation was denied. The taxpayer's claim to a business reason—that it acquired the corporation as an affiliate because of the potential value of its assets—did not, this Court held (p. 128) "over-shadow the conclusion that the acquisition was for a huge potential tax benefit." Here,

as in *American Pipe & Steel* (p. 128), after the acquisition of the stock of the corporation and the liquidation of its assets, the purported affiliate "was a mere corporate shell." And in *Elko Realty,* as the Court below pointed out (R. 90), while the taxpayer never saw the books of the two acquired corporations prior to purchasing their stock, nevertheless the taxpayer *had reason to know* that the corporations were operating at a loss. The case here is stronger than *Elko;* the taxpayer here emphasizes that it never saw the books of Hilo Gas before its purchase of the stock, but the significant fact is that the taxpayer here *actually knew* that Hilo Gas was in financial difficulty, and that its manufacturing plant was obsolete and its manufacturing costs were high. (R. 29-31.)

The taxpayer's objections to the finding below, as well as its efforts to distinguish the decided cases, are, we submit, without merit. The taxpayer's argument, essentially, is that the acquisition of Hilo Gas as a corporate entity was for a business purpose, not to avoid taxes, because at the time it acquired the stock of Hilo Gas, no consideration was given by it to the tax aspects of the transaction, it did not know what the book value of the Hilo Gas assets was until after it had decided to purchase the stock, and its primary interest in Hilo Gas was that the Hilo Gas distribution system and market would furnish the taxpayer with an outlet for its product. The fallacy in the taxpayer's argument, however, is that the facts of business purpose, which we do not dispute, justified the acquisition by the taxpayer of the *assets* of Hilo Gas and the liquida-

tion of Hilo Gas as *a corporate entity*, precluding its continuance in existence as an affiliate of the taxpayer. Indeed, this was exactly what the taxpayer intended at the time that it purchased the stock of Hilo Gas. (R. 43.) It had arranged for the sale of virtually all of the assets of Hilo Gas prior to purchase of the stock. The taxpayer proceeded to carry out its plan to liquidate Hilo Gas as a corporation. On October 31, 1950, the assets were sold and Hilo Gas was only a corporate shell bound for dissolution. (R. 44.) The later revival of Hilo Gas as a corporation in November, 1950, to continue in existence as an affiliate of the taxpayer was admittedly prompted by tax considerations (R. 42-43); it had no business purpose, and the taxpayer can show none. The taxpayer had provided for the operation of the business formerly conducted by Hilo Gas through Honolulu Gas and itself; it had no need of Hilo Gas as a lessor, and the possible uses of Hilo Gas for other purposes were outshadowed by its actual use as a tax loss corporation.

The continued existence of Hilo Gas as a corporate entity was of no value to the taxpayer except as a tax loss and its acquisition for that purpose thus violated the basic principle underlying Section 129. As the Senate Committee Report states (S. Rep. No. 627, *supra*, p. 60 (1944 Cum. Bull., p. 1017)): "Basic to the deduction, credit, and allowance provisions is a continuing enterprise so conducting its affairs." This is the principle of the decisions in *British Motor Car Distributors, Ltd., supra; American Pipe & Steel Corp., supra;* and *Elko Realty Co., supra.* The deci-

sion below is correct as a matter of fact and law. Viewing the entire transaction involved, it becomes clear that the acquisition of Hilo Gas as a corporate entity, distinguished from its assets was primarily for the purpose of evading or avoiding taxes upon the income of the taxpayer, within the terms and spirit of Section 129.

B. Apart from Section 129, the taxpayer's claim to the deduction is prohibited by other specific provisions and basic principles of the revenue laws

As we have already noted, Section 129 is only one of the measures which stands as a bar against the evasion or avoidance of income taxes through the use of artificial corporate devices which distort income. Indeed, the Court below held that, apart from Section 129, the taxpayer here was not entitled to the privilege of filing consolidated returns under Section 141, Appendix, *infra,* in order to secure the benefit of the Hilo Gas loss. In the words of the Court below (R. 87) this privilege may not "be utilized to distort income by acquiring a 'loss corporation' for a nominal consideration, and then using such corporation's losses to avoid taxes." *David's Specialty Shops v. Johnson,* 131 F. Supp. 458 (S.D. N.Y.); *J.D. & A.B. Spreckels Co. v. Commissioner,* 41 B.T.A. 370. The *Spreckels* case, approved by Congress (see S. Rep. No. 627, *supra,* p. 60) is, we submit, on all fours with the case at bar. The case of *Bishop Trust Co. v. Commissioner,* 36 B.T.A. 1173, upon which the taxpayer relies, is factually distinguishable. There the taxpayer acquired another trust

company in order to liquidate it without loss to its investors, thereby preventing the spread of financial panic which would have endangered the taxpayer and also securing for itself the good will and future patronage of the investors in the acquired corporation.

Moreover, even if the privilege of filing consolidated returns were to be allowed to the taxpayer here, the Commissioner had ample authority to disallow the particular claimed deduction by allocating it solely to Hilo Gas, in order to prevent a distortion of income. The authority so to allocate is expressly provided in connection with consolidated returns by Section 141(b), and by Section 141(i) in conjunction with Section 45, Appendix, *infra.* It is a necessary check upon the abuse of the privilege of filing consolidated returns. *National Securities Corp. v. Commissioner,* 137 F. 2d 600 (C. A. 3d). In that case, the Court held that a parent corporation, which had sustained the major loss on a stock investment, could not maintain the transfer of the loss to a subsidiary by transfer of the stock, against the Commissioner's allocation of the loss to it, rather than the subsidiary, under Section 45.

In addition to specific statutory provisions, the taxpayer's claim to a deduction was properly denied because the taxpayer is not the corporate entity or enterprise which suffered the loss. As far as it is concerned, the property sold for $84,500 cost it $63,897. The general rule is that the taxpayer "who sustained the loss is the one to whom the deduction is allowed." *New Colonial Co. v. Helvering,* 292 U. S. 435, 440-441; *Libson Shops Co. v. Koehler,* 353 U. S. 282; *Bookwalter v.*

Hutchens Metal Products Co. (C. A. 8th), decided June 30, 1960 (6 A.F.T.R. 2d 5068); *Mill Ridge Coal Co. v. Patterson,* 264 F. 2d 713 (C. A. 5th). A taxpayer may not, by acquisition of, or merger or consolidation with another corporate entity which is at the time a mere corporate shell, claim for itself the tax loss suffered by the other, particularly the loss which reduced it to a shell. Furthermore, the continuance of Hilo Gas as a corporate entity affiliated with the taxpayer, was a meaningless transaction; the carrying out of the challenged tax event, i.e., the maintenance of a period of affiliation during which a loss occurred, was "unreal or a mere sham" which may be disregarded for tax purposes. *Higgins v. Smith,* 308 U. S. 473, 477.

Finally, the transaction upon which the taxpayer here relies to show innocence of tax evasion and a business purpose was a transaction for the acquisition of the assets of Hilo Gas, through purchase of its stock. In such a transaction the *only* real basis for gain or loss to the acquiring taxpayer is the cost of the stock to it, not the cost basis to the acquired or transferor corporation. *United States v. Mattison,* 273 F. 2d 13 (C. A. 9th); *United States v. M.O.J. Corp.,* 274 F. 2d 713 (C. A. 5th); *Georgia-Pacific Corp. v. United States,* 264 F. 2d 161 (C. A. 5th); *Kanawha Gas & Utilities Co. v. Commissioner,* 214 F. 2d 685 (C. A. 5th); *Commissioner v. Ashland Oil & R. Co.,* 99 F. 2d 588 (C. A. 6th); *Prairie Oil & Gas Co. v. Motter,* 66 F. 2d 309 (C. A. 10th); *Kimbell-Diamond Milling Co. v. Commissioner,* 14 T. C. 74; *Muskegon Motor Spe-*

cialists Co. v. Commissioner, 35 B.T.A. 851. The rule (known as the *Kimbell-Diamond* rule) has been applied where the assets were acquired by the taxpayer in a two-step transaction of purchase of the stock of a corporation and surrender of the stock for assets, dissolving or liquidating the corporation itself. But the principle is clearly applicable to a case where the taxpayer purchases the stock in order to sell the assets to itself or another, to be followed by liquidation of the corporation. The difference between the two cases is not material: In one the liquidation of the corporation is accomplished simultaneously with the liquidation of its assets; in the other the liquidation of the corporation follows the liquidation of its assets. In both the purpose is to acquire assets, not stock. As this Court said in *United States v. Mattison* (273 F. 2d, p. 17):

> * * * when a taxpayer who is interested primarily in a corporation's assets first purchases the stock and then liquidates the corporation in order to acquire the desired assets, the separate steps taken to accomplish the primary objective will be treated as a single transaction. Thus, even though the objective was accomplished in form by a purchase of stock, the substance of the transaction is a purchase of property.

Here, too, as in *Mattison* (p. 19), the intention to acquire assets is confirmed by the fact that the objective was "to consummate a pre-arranged sale of the assets."

Moreover, where the transaction is one to acquire assets, the fact that the purchased corporation was

kept alive for a temporary period and that during this period consolidated returns were filed for it and its new parent, the purchaser, is not decisive. The fact of consolidated returns does not alter the essential or real nature of the transaction as a purchase of assets having a basis to the purchaser, for tax purposes, of the price of the stock. *Commissioner v. Ashland Oil & Gas Co., supra, Kanawha Gas & Utilities Co. v. Commissioner, supra* (214 F. 2d, pp. 689-691); *Muskegon Motor Specialties Co. v. Commissioner, supra.* The original cost basis to the acquired corporation is not a real measure of gains or losses to the acquiring corporation, and it does not become a real measure because the acquiring corporation files consolidated returns with the corporate shell of the acquired corporation.

II

THE DISTRICT COURT CORRECTLY HELD THAT THE TAXPAYER MAY NOT DEDUCT THE AMOUNT OF TERRITORIAL TAXES ALLOCABLE TO GAIN NOT SUBJECT TO FEDERAL TAX

The second question in this case arises not out of the liquidation of Hilo Gas, but out of the liquidation of the taxpayer itself. Briefly stated, on November 25, 1955, the stockholders of the taxpayer adopted a plan for its complete liquidation, to be accomplished by the sale of its refinery assets to Standard Oil and of its bottled gas business to Honolulu Gas. This liquidation sale was completed within a year and re-

sulted in gains, but under Section 337 of the 1954 Code, Appendix, *infra*, the gain was not recognizable to the taxpayer. The gain was, however, taxable to the taxpayer under the Hawaii territorial tax law and in 1955 the taxpayer paid a Hawaii income tax of $74,408.15 of which $61,061.59 was allocable to the gains from the liquidation sale. This allocable portion of the gains was claimed by the taxpayer as a deduction on its federal income tax return but disallowed by the Commissioner under Section 265 of the 1954 Code, Appendix, *infra*, and the disallowance was sustained by the Court below. We submit that the decision below is correct because (1) Section 265 prohibits the deduction of taxes allocable to tax-exempt income; and (2) the gains to the taxpayer from its liquidation sale were wholly exempt from federal income tax within the meaning of Section 337.

A. Section 265 requires the disallowance of taxes allocable to income exempt from federal tax

Section 265(1) provides that no deduction shall be allowed for "(1) *Expenses.*—Any amount otherwise allowable as a deduction which is allocable to one or more classes of income * * * wholly exempt" from income tax. The taxpayer contends that taxes are not "expenses" and are therefore not covered by Section 265 at all, regardless of whether the taxes are allocable to exempt income. As the taxpayer admits, however, there is no ruling to this effect. On the contrary, it has been consistently held by prior decisions of the Tax Court that the predecessor to Sec-

tion 265 (Section 24(a)(5) of the 1939 Code) did apply to taxes. *Marsman v. Commissioner,* 18 T. C. 1, affirmed on other grounds, 205 F. 2d 343; *Heffelfinger v. Commissioner,* 5 T. C. 985; *Curtis v. Commissioner,* 3 T. C. 648; *Keith v. Commissioner,* decided December 9, 1942 (P-H T. C. Memorandum Decisions, par. 42,630); *Halleran v. Commissioner,* decided August 10, 1942 (P-H T. C. Memorandum Decisions, par. 42,456).

There is no reason for disturbing these decisions, especially since the section has been substantially re-enacted by Congress. The only argument the taxpayer has is that the sub-heading of the section refers only to expenses, and "expenses" are for *some,* not all, tax purposes distinguished from "taxes"; the taxpayer concedes that the terms are not mutually exclusive. (Br. 82.) Moreover, the substantive terms of the revenue statute involved here apply to "any amount otherwise allowable as a deduction" which clearly includes taxes; and the sub-heading cannot control the plain meaning of the substantive terms of the section. *United States v. Minker,* 350 U.S. 179, 185. The taxpayer's claim (Br. 80) that, by adding the heading "expenses" in the 1954 Code, Congress intended to limit the prior scope of the section which otherwise is the language of Section 24(a)(5) of the 1939 Code, as amended, is directly refuted by the express declarations of Congress. The Senate and House Committee Reports state as follows (H. Rep. No. 1337, 83d Cong., 2d Sess., p. A65 (3 U.S.C. Cong. & Adm. News (1954), pp. 4017, 4202), S. Rep. No.

1622, 83d Cong., 2d Sess., p. 226 (3 U.S.C. Cong. & Adm. News (1954), pp. 4621, 4862):

> Subsection (a) is the same as section 24(a)(5) of the 1939 Code. Subsection (b) contains the same rule as section 23(b) of the 1939 Code. No substantive changes are made in either of these provisions.

B. The gains from the sale and liquidation of the taxpayer were wholly exempt from tax within the meaning of Section 265

The purpose of Section 265 seems clear enough. It is intended to disallow a deduction which is directly connected with a non-taxable gain.[3] The taxpayer argues that the gain from the sales and liquidation of a corporation are not "exempt" from tax but are "not recognized" for tax purposes. (Br. 70.) This verbal distinction, according to the taxpayer, has a substantive basis, to-wit: The tax on gain which is not recognized is simply postponed and will eventually have to be paid, and therefore the gain is not "wholly exempt" from taxation. It is not necessary here to determine whether the term "wholly exempt" as used in Section 265 includes gain "not recognized", since under Section 337, the gain from the liquidation sales of a corporation is wholly exempt from tax to the corporation; the tax is not merely postponed. As the taxpayer's own argument demonstrates (Br. 70-75) the purpose of Section 337 was to provide for only

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[3]It is worth noting that even before the predecessor Section 24(a)(5) was enacted, it was held on *principle* that expenses of producing non-taxable income were not deductible. *Lewis v. Commissioner,* 47 F. 2d 32 (C. A. 3d).

one tax upon the gains from the liquidation sale of a corporation—to its stockholders, and not to the corporation.[4] The corporation itself, the taxpayer here, will never pay a tax on these gains, since it is to be dissolved and its existence, as a taxpayer and otherwise, terminated.

In this light, the decision in *Cotton States Fertilizer Co. v Commissioner,* 28 T. C. 1169, is not in point, since there the tax was merely postponed, not wholly relieved. Similarly, the decisions in the cases involving expenses of liquidation cited by the taxpayer (*Commissioner v. Wayne Coal Mining Co.,* 209 F. 2d 152 (C. A. 3d); *United States v. Arcade Co.,* 203 F. 2d 230 (C. A. 6th); *Pacific Coast Biscuit Co. v. Commissioner,* 32 B. T. A. 39; *Tobacco Products Export Corp. v. Commissioner,* 18 T. C. 1100) are not in point since the expenses there involved were general expenses of a liquidation, incurred regardless of the gains or losses from liquidation sales; the issue in those cases was whether such expenses were necessary and ordinary expenses, not whether they were allocable to tax-exempt income.

[4]Moreover, the gains to the stockholders will be measured by a different basis than the gain to the corporation—the cost or basis of their stock, not the cost or other basis of the assets to the corporation.

CONCLUSION.

The decision of the District Court is correct and should be affirmed.

Respectfully submitted,

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September, 1960.

(Appendix Follows.)

Appendix.

Appendix

Internal Revenue Code of 1939:

SEC. 45. [as amended by Section 128(b) of the Revenue Act of 1943, c. 63, 58 Stat. 211]. ALLOCATION OF INCOME AND DEDUCTIONS.

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.
>
> (26 U. S. C. 1952 ed., Sec. 45.)

SEC. 129. [as added by Section 128(a) of the Revenue Act of 1943, *supra*]. ACQUISITIONS MADE TO EVADE OR AVOID INCOME OR EXCESS PROFITS TAX.

> (a) *Disallowance of Deduction, Credit, or Allowance.*—If (1) any person or persons acquire, on or after October 8, 1940, directly or indirectly, control of a corporation, or (2) any corporation acquires, on or after October 8, 1940, directly or indirectly, property of another corporation, not

controlled, directly or indirectly, immediately prior to such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For the purposes of clauses (1) and (2), control means the ownership of stock possessing at least 50 per centum of the total combined voting power of all classes of stock entitled to vote or at least 50 per centum of the total value of shares of all classes of stock of the corporation.

(b) *Power of Commissioner to Allow Deduction, Etc., in Part.*—In any case to which subsection (a) is applicable the Commissioner is authorized—

(1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made; or

(2) to distribute, apportion, or allocate gross income, and distribute, apportion, or allocate

the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated, but to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made; or

(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2). (26 U. S. C. 1952 ed., Sec. 129.)

SEC. 141 [as amended by Section 301, Excess Profits Tax Act of 1950, c. 1199, 64 Stat. 1137]. CONSOLIDATED RETURNS.

(a) *Privilege to File Consolidated Returns.*—An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making a consolidated return for the taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under subsection (b) prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of

the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.

(b) *Regulations.*—The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income- and excess-profits-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

* * * *

(i) *Allocation of Income and Deductions.*—For allocation of income and deductions of related trades or business, see section 45.

* * * *

(26 U. S. C. 1952 ed., Sec. 141.)

Internal Revenue Code of 1954:

SEC. 265. EXPENSES AND INTEREST RELATING TO TAX-EXEMPT INCOME.

No deduction shall be allowed for—

(1) *Expenses.*—Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest

(whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this subtitle, or any amount otherwise allowable under section 212 (relating to expenses for production of income) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this subtitle.

* * * *

(26 U. S. C. 1958 ed., Sec. 265.)

SEC. 337. GAIN OR LOSS ON SALES OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS.

(a) *General Rule.*—If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

* * * *

(26 U. S. C. 1958 ed., Sec. 337.)

Treasury Regulations on Income Tax (1954 Code):

SEC. 1.265-1. EXPENSES RELATING TO TAX-EXEMPT INCOME.—NONDEDUCTIBILITY OF EXPENSES ALLOCABLE TO EXEMPT INCOME.

* * * *

(b) *Exempt income and nonexempt income.*—(1) As used in this section, the term "class of exempt income" means any class of income (whether or not any amount of income of such class is received or accrued) wholly exempt from the taxes imposed by subtitle A of the Internal Revenue Code of 1954. For purposes of this section, a class of income which is considered as wholly exempt from the taxes imposed by subtitle A includes any class of income which is—

(i) Wholly excluded from gross income under any provision of subtitle A, or

(ii) Wholly exempt from the taxes imposed by subtitle A under the provisions of any other law.

(2) As used in this section the term "nonexempt income" means any income which is required to be included in gross income.

* * * *